



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date:	04/30/13	Bill No:	Senate Bill 376
Tax Program:	Sales and Use Tax	Author:	Correa
Sponsor:	Author	Code Sections:	RTC 6377.4
Related Bills:	SB 235 (Wyland) SB 412 (Knight) AB 486 (Mullin) AB 653 (V. Perez) AB 1326 (Gorell)	Effective Date:	Upon enactment but exemption operative 01/01/17

BILL SUMMARY

Beginning January 1, 2017, the bill provides manufacturers and software publishers a 6.25% sales and use tax exemption for their qualifying tangible personal property purchases.

Summary of Amendments

Since the previous analysis, this bill was amended to, among other things, add a five-year sunset date of January 1, 2022 and delete the proposed exemption for a qualified person's affiliates.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law¹ imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment. A software publisher's taxable purchases include computer equipment, such as servers, routers, switches, power units, network devices, hard drives, processors, memory modules, and other computer hardware and components.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate the property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). Existing law² contains a specific sales and use tax exclusion³ for tangible

¹ Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code (RTC).

² RTC Section 6010.8.

personal property purchased for certain approved manufacturing projects. In 2010, legislation⁴ authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property used for the design, manufacture, production, or assembly of advanced transportation technologies, alternative energy source products, components or systems. In 2012, legislation⁵ was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law⁶ provides a \$100 million cap for these exclusions.

CAEATFA's approval of the exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

California's sales and use tax rates. Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on taxable tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Until 12/31/16, schools and community college funding (Section 36, Article XIII, State Constitution).
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

PROPOSED LAW

From January 1, 2017 to January 1, 2022, this bill provides a 6.25% sales and use tax exemption for a "qualified person's" purchases of:

- Tangible personal property to be used 50% or more in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.

³ An "exclusion" means the transfer of the property is neither a "sale" or "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.

⁴ SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).

⁵ SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).

⁶ Public Resources Code Section 26011.8.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.

- Tangible personal property to be used 50% or more in research and development (R&D).
- Tangible personal property to be used 50% or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must use the property, however, as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.

This bill defines "qualified person" as a trade or business that is primarily engaged in manufacturing activities, as described in the 2012 edition of the North American Industry Classification System (NAICS) codes 3111 to 3399, inclusive, and software publishing activities as described in code 5112.

The bill defines "fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life." The bill also specifies the tangible personal property included or excluded from the proposed partial exemption.

The proposed partial exemption excludes:

- Any tangible personal property primarily used in administration, general management, or marketing,
- Consumables with less than a one year useful life, and
- Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process.

The bill excludes from the exemption any city, county, or district tax levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law. The proposed exemption includes the remaining state and local sales and use tax components⁷ (except for the .25% Education Protection Account which expires December 31, 2016).

The bill also requires the Legislative Analyst's Office (LAO) to conduct a study by January 1, 2019, using BOE information, to measure the effects of the proposed exemption, as specified.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,⁸ less aerospace

⁷ 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Fiscal Recovery Fund, 0.50% Local Public Safety Fund, and 0.50% Local Revenue Fund.

⁸ As determined by the Employment Development Department

employment, failed to exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, the employment figures fell below the 1994 number by over 10,000. The partial exemption and MIC therefore sunset at the end of 2003.

Legislative History. Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology R&D, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, R&D, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology R&D, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and R&D activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments, by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production
AB 2280	2009-10	Miller	Full exemption for manufacturing.
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities

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Bill No.	Session	Author	Proposed Exemption
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates

COMMENTS

- 1. Sponsor and Purpose.** Sponsored by the California Manufacturers and Technology Association, this bill intends to help level the playing field with California's competitors. According to the author, "Today, there are only four other states that do not provide some exemption for equipment purchases from payment of sales tax. This burden is relatively large in California due to the high rate of sales tax in the state and a complex regulatory environment. California has long been recognized as a national leader of manufacturing, but in recent years, California manufacturers have been crippled by high taxes and overly burdensome regulations. To remain competitive, we must support meaningful economic incentives that will keep businesses and good paying jobs in California."
- 2. The April 30, 2013 amendments** add a five-year sunset date of January 1, 2022, and delete the provision that would have extended the proposed exemption to a qualified person's affiliates. Also, as suggested in the BOE's prior analysis, the amendments add "tangible personal" before property, and clarify that a "qualified person" is one that is *primarily* engaged in aerospace product and part manufacturing. The amendments further require the LAO, with BOE-provided information, to conduct a study, as specified.
- 3. NAICS Codes 3111 to 3399 and 5112 include manufacturers and software publishers, respectively.** NAICS Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, and more.

NAICS Code 5112 includes establishments primarily engaged in computer software publishing or publishing and reproduction. Software publishing establishments carry out the functions necessary for producing and distributing computer software. This includes activities such as design, documentation, installation, and support services to software purchasers. The software publishing industry produces and distributes information mostly by CD-ROMs, through the sale of new computers with preloaded software, or through the Internet.
- 4. Partial exemptions complicate tax administration.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, California law contains five partial exemptions, currently at a 5.50%⁹ rate:
 - (1) Farm equipment and machinery,
 - (2) Diesel fuel used for farming and food processing,
 - (3) Teleproduction and postproduction equipment,
 - (4) Timber harvesting equipment and machinery, and
 - (5) Racehorse breeding stock.

These partial tax exemptions complicate retailers' return preparation and processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

⁹ 3.9375% General Fund, 1.0625% Local Revenue Fund, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

Also, this bill proposes a new 6.25% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 6.25% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a sale for resale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administrative functions and retailers' reporting obligations become more complicated.

5. BOE may not have all the LAO report information. By January 1, 2019, the bill requires the LAO, with BOE-provided information, to measure the following:

- (1) The exemption's effect on manufacturing, R&D, and associated industries' employment levels,
- (2) New and expanded manufacturing and R&D facilities' locations resulting from the proposed exemption.
- (3) The exemption's effect on manufacturing equipment capital investments and all other tangible personal property, the sale or use of which qualified for the partial exemption.

The BOE will have data that tracks retailers' claimed exemptions, and qualified persons' claimed purchases (when they report the remaining one percent or more use tax due). However, the BOE does not have employment information. Perhaps for the required study the Employment Development Department should provide this data to the LAO. Also, while the BOE may have new California facilities information based on new manufacturers' or software producers' seller's permit applications, we would not necessarily have specific data related to expanded facilities.

6. Related legislation. Similar bills introduced this year include:

- **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.
- **SB 412 (Knight)** – provides aerospace product and part manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.
- **AB 486 (Mullin)** – provides manufacturers, software producers, various researchers and developers, and their affiliates, a 5.25% exemption for their qualifying tangible personal property purchases.
- **AB 653 (V. Perez)** – provides manufacturers, software publishers, biotechnology research entities, and renewable power generator facilities, and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
- **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.

COST ESTIMATE

A cost estimate is pending to determine costs to reprogram for the partial exemption, revise and process returns, notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public.

REVENUE ESTIMATE**BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

NAICS 31-33 (Manufacturing). The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated \$11 billion. We assume this amount includes manufacturers' research and development-related capital expenditures.

NAICS 5112 (Software Publishers). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S. capital expenditures data (machines and equipment, buildings) for software publishers. For California expenditures, we looked at the 2007 *Economic Census* software publishers' data and estimated that the ratio of California to U.S. revenue or sales receipts for software publishers equals 28%. We applied the 28% to U.S. capital expenditures (ACES). In FY 2010-11, California software publishers' capital expenditures amounted to an estimated \$1.4 billion.

For FY 2010-11, census data reveals total capital expenditures of \$12.4 billion (NAICS 31-33, \$11 billion + NAICS 5112, \$1.4 billion).

The partial sales and use tax exemption becomes operative January 1, 2017. Using the most recent forecast of business equipment investment from *IHS Global Insight*, a national economic forecasting firm, we estimated expenditures as follows:

Capital Expenditures – California (in billions)

	FY 2016-17	FY 2017-18
NAICS 31-33	\$18.3	\$19.2
NAICS 5112	\$2.2	\$2.3
	\$19.2	\$20.2

REVENUE SUMMARY

The annual revenue loss from exempting from 6.25% sales and use tax for manufacturers' (NAICS 31-33) and software publishers (NAICS 5112) purchases of qualifying tangible personal property amounts to:

Sales & Use Tax Loss (in billions)

	(6 month impact) FY 2016-17	FY 2017-18
State Rate 6.25%	\$0.60	\$1.26

Qualifying Remarks. The revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately \$37 million in 2010, \$4.7 million in 2011, and \$8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases

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authorized by the 2012 legislation. However, the law caps the allowable sales and use tax exclusions for both programs at \$100 million annually.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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